

## Management's Discussion and Analysis

As managers of the state of Washington, we offer this narrative overview and analysis of the financial activities for the fiscal year ended June 30, 2002. We present this information in conjunction with the information included in our letter of transmittal, which can be found preceding this narrative, and with the state's financial statements, which follow.

The state implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34 *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* (GASB 34) in Fiscal Year 2002. The GASB establishes reporting standards for state and local governments whereas the state's budget is the responsibility of state elected officials and officers. Statement No. 34 dramatically impacted the form and content of the state's financial statements, but did not change the underlying legal requirements related to the state's budget. Because Fiscal Year 2002 is the first year we have presented financial data in accordance with the new reporting requirements, this discussion and analysis provides limited comparisons with the previous year. Future reports will include more comparisons. All amounts, unless otherwise indicated, are expressed in thousands of dollars.

### Financial Highlights

- Total assets of the state of Washington exceeded its liabilities by \$15.0 billion (reported as *net assets*). Of this amount, \$2.3 billion was reported as "unrestricted net assets." Unrestricted net assets represent the amount available to be used to meet the State's ongoing obligations to citizens and creditors.
- The state of Washington's governmental funds reported combined ending fund balances of \$7.1 billion, a decrease of \$368 million in comparison with the prior year.
- Unreserved fund balance for the General Fund was \$398 million, or 2.5% percent of total General Fund expenditures.
- The state's capital assets increased by \$914 million while total bond debt increased by \$543 million during the current fiscal year.

### Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the state of Washington's basic financial statements. The state of Washington's basic financial statements include three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements.

With the implementation of GASB 34, we have changed the presentation of the state's financial statements. The new focus is on both the state as a whole (government-wide) and the major individual funds. The dual perspectives allow the reader to address relevant questions, broaden a basis for comparison (year to year or government to government) and enhance the state's accountability.

**Government-wide Financial Statements** - The *government-wide financial statements* are designed to provide readers with a broad overview of the state of Washington's finances, in a manner similar to a private sector business.

The *Statement of Net Assets* presents information on all of the state of Washington's assets and liabilities, with the difference between the two reported as *net assets*. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the state of Washington is improving or deteriorating.

The *Statement of Activities* presents information showing how the state's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, *regardless of the timing of related cash flows*. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave). The Statement of Activities is focused on both the gross and net cost of various activities (including governmental, business-type and component unit). This is intended to summarize and simplify the reader's analysis of the revenues and costs of various state activities and the degree to which activities are subsidized by general revenues.

Both of the government-wide financial statements distinguish functions of the state of Washington that are principally supported by taxes and intergovernmental revenues (*governmental activities*) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities*). The governmental activities of the state of Washington include education, human services, transportation, natural resources, adult corrections and general government. The business-type activities of the state of Washington include the workers' compensation, unemployment compensation and health insurance programs, as well as various higher education student services such as housing and dining.

The government-wide financial statements can be found on pages 35-37 of this report.

**Fund Financial Statements** - Traditional readers of governmental financial statements will find the Fund Financial Statements presentation familiar. However, the focus is now on major funds, rather than fund types.

A *fund* is a grouping of related accounts used to maintain control over resources that are segregated for specific activities or objectives. The state of Washington, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the state can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

**Governmental Funds.** *Governmental funds* are used to account for essentially the same functions reported as *governmental activities* in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on *near-term inflows and outflows of spendable resources*, as well as on *balances of spendable resources* available at the end of the fiscal year. Such information may be useful in evaluating a government's near term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for *governmental funds* with similar information presented for *governmental activities* in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between *governmental funds* and *governmental activities*.

Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for three major funds and an aggregate total for all non-major funds. The state's major governmental funds are the General Fund, Higher Education Special Revenue Fund, and the Higher Education Endowment Permanent Fund. Individual fund data for each of the non-major governmental funds is provided in the form of *combining statements* elsewhere in this report.

The governmental fund financial statements can be found on pages 40-42 of this report.

**Proprietary Funds.** - The state of Washington maintains two different types of proprietary funds. *Enterprise funds* are used to report the same functions presented as *business-type activities* in the government-wide financial statements. *Internal service funds* represent an accounting device used to accumulate and allocate costs internally among the state of Washington's various functions. The state of Washington uses internal service funds to account for general services such as motor pool and central stores, data processing services, and printing services. Because internal service funds predominately benefit governmental rather than business-type functions, they have been included within *governmental activities* in the government-wide financial statements.

Proprietary fund financial statements provide the same type of information as the government-wide financial statements, but in greater detail. The proprietary fund financial statements provide separate information for Workers Compensation and Unemployment Compensation Funds, which are considered to be major funds, as well as an aggregated total for all non-major enterprise funds. The internal service funds are combined for presentation purposes. Individual fund data for the state's non-major proprietary funds are provided in the form of *combining statements* elsewhere in this report.

The proprietary fund financial statements can be found on pages 43-46 of this report.

**Fiduciary Funds.** Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are *not* reflected in the government-wide financial statement because the resources of those funds are *not* available to support the state of Washington's own programs. Washington's fiduciary funds include state administered pension plans. The accounting used for fiduciary funds is much like that used for proprietary funds.

The fiduciary fund financial statements can be found on pages 47-48 of this report.

**Component Units.** Component units are entities which are legally separate from the state but which are financially accountable to the state. The state has one major component unit, the Washington State Public Stadium Authority, and four non-major component units. Refer to Note 1 on page 53 for more detail information.

The financial statements for the state's component units can be found on pages 49-51 of this report.

**Notes to the financial statements.** The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 52-106 of this report.

**Other required information.** In addition to this discussion and analysis, this report also presents required supplementary information on budgetary comparisons, pension plan funding, and infrastructure assets reported using the modified approach. Required supplementary information can be found on pages 107-125 of this report.

The combining statements referred to earlier are presented immediately following the required supplementary information. Combining and individual fund statements and schedules can be found on pages 127-186 of this report.

## Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. For the state of Washington, total assets exceed liabilities by \$15.0 billion at June 30, 2002.

The largest portion of the state's net assets (57.5 percent) reflects its investment in capital assets (e.g., land, buildings, machinery, and equipment), less any related debt used to acquire those assets that is still outstanding.

The state of Washington uses these capital assets to provide services to citizens; consequently, these assets are *not* available for future spending. Although the state of Washington's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

### State of Washington's Net Assets

(in millions of dollars)

	Governmental Activities	Business-type Activities	Total
Current and other assets	\$ 11,682	\$ 13,405	\$ 25,087
Capital assets	18,957	1,114	20,071
Total assets	30,639	14,519	45,158
Long-term liabilities outstanding	9,491	16,460	25,951
Other liabilities	3,005	1,234	4,239
Total Liabilities	12,496	17,694	30,190
Net assets:			
Invested in capital assets, net of related debt	8,253	355	8,608
Restricted	2,153	1,883	4,036
Unrestricted	7,737	(5,413)	2,324
Total net assets	\$ 18,143	\$ (3,175)	\$ 14,968

A portion of the state of Washington's net assets (27.0 percent) represents resources that are subject to constitutional or external restrictions on how they may be used. The remaining balance of *unrestricted net assets* may be used to meet the state's ongoing obligations to citizens and creditors.

### State of Washington's Changes in Net Assets

(in millions of dollars)

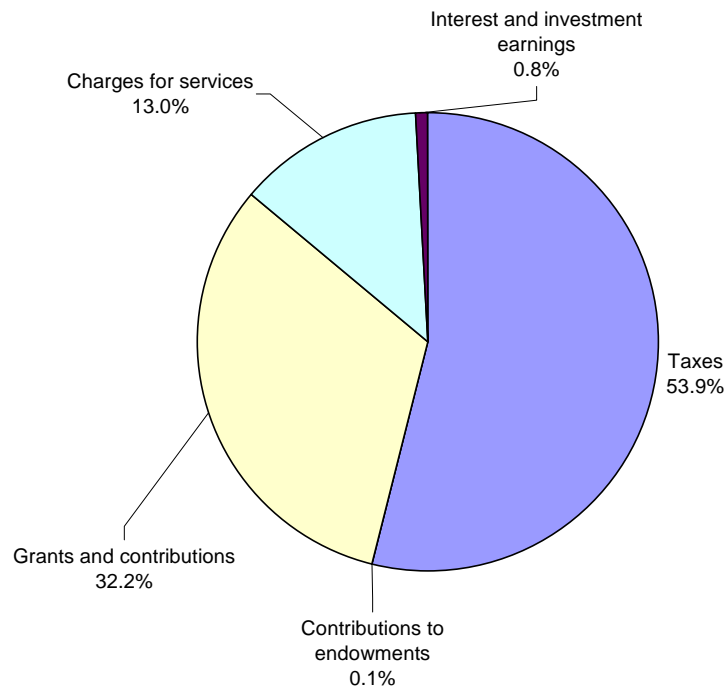
	Governmental Activities	Business-type Activities	Total
Program revenues:			
Charges for services	\$ 2,906	\$ 4,987	\$ 7,893
Grants and contributions	7,182	269	7,451
Total	10,088	5,256	15,344
Program expenses	(22,923)	(6,747)	(29,670)
	(12,835)	(1,491)	(14,326)
General revenues:			
Taxes	12,030	83	12,113
Interest and investment earnings	189	613	802
Contributions to endowments	29	-	29
Excess(deficiency) of revenues over expenses before transfers	(587)	(795)	(1,382)
Transfers	148	(148)	-
Increase(decrease) in net assets	(439)	(943)	(1,382)
Net assets - July 1, 2001	18,582	(2,232)	16,350
Net assets - June 30, 2002	\$ 18,143	\$ (3,175)	\$ 14,968

As previously mentioned, the state's activities are divided between governmental and business-type. The majority of support for governmental activities comes from taxes and intergovernmental grants, while the business-type activities are supported primarily through user charges.

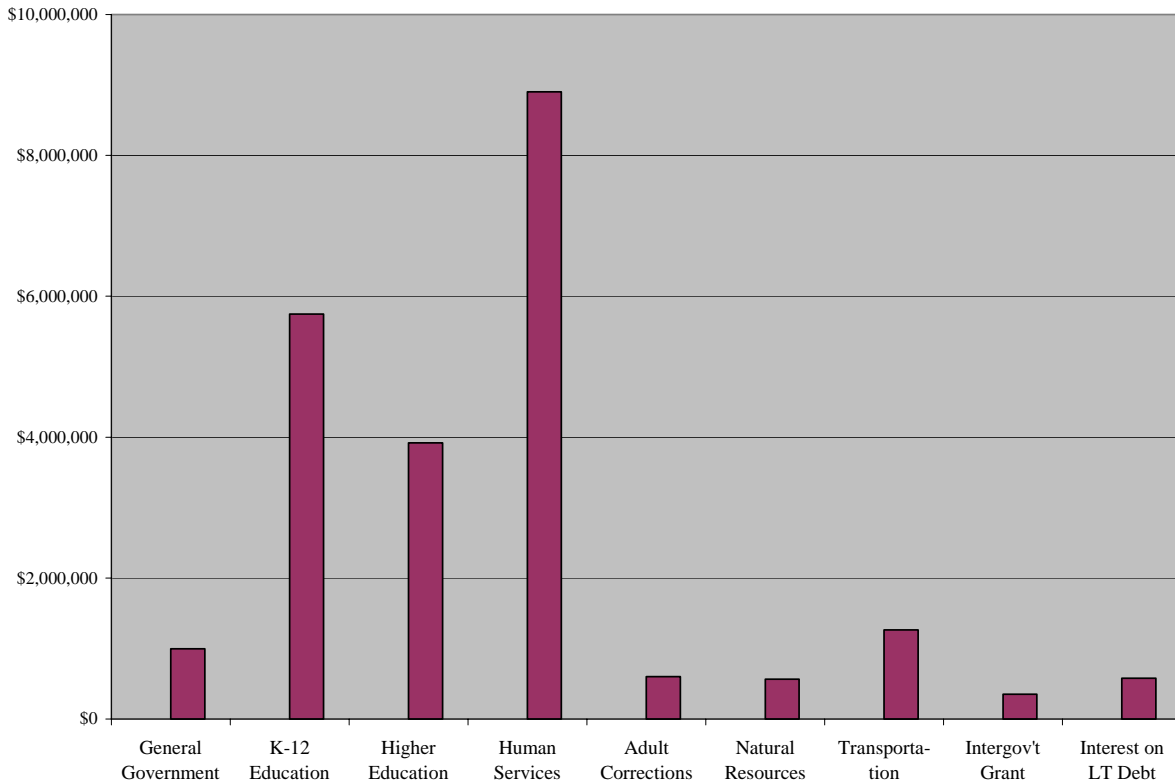
**Governmental activities.** Governmental activities resulted in a net reduction in the state of Washington's net assets of \$439 million. Key elements of this decrease are as follows:

- Demand for services increased while tax revenues held fairly static necessitating the use of \$335 million of emergency reserves.
- Claims expenses exceeded revenues in the state's Risk Management Fund by \$124 million.

### Revenues by Source – Governmental Activities



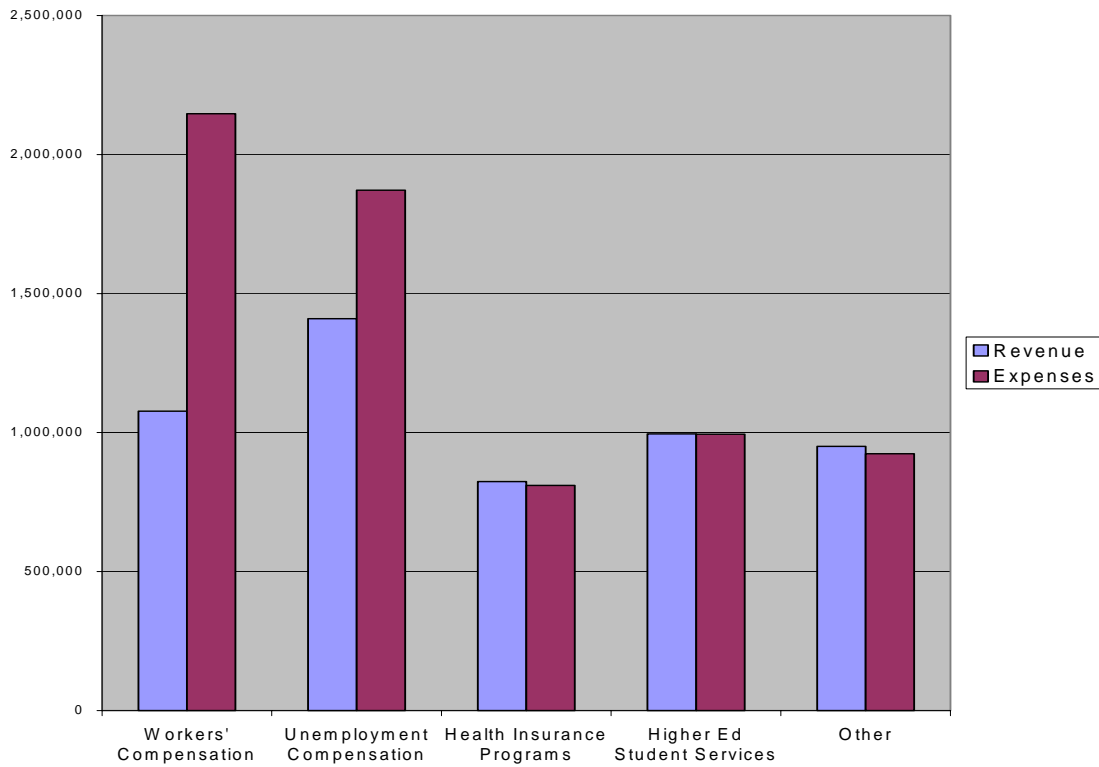
### Expenses – Governmental Activities



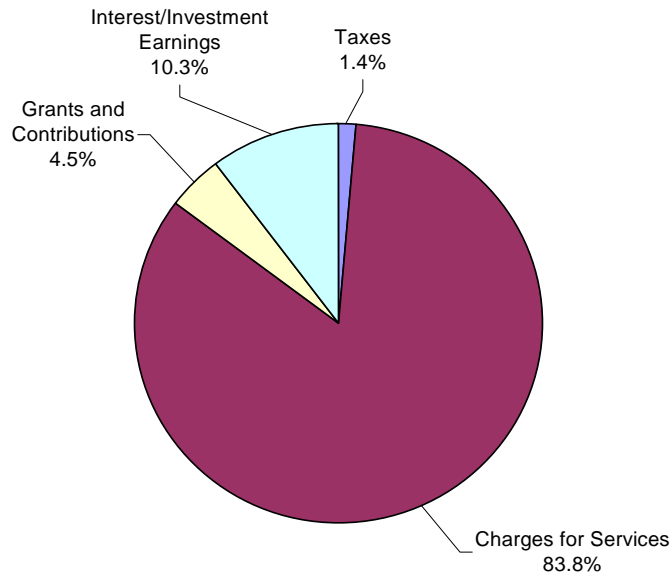
**Business-type activities.** Business-type activities decreased the state of Washington’s net assets by \$943 million, a 40 percent decrease in the state’s unrestricted net assets. The two main causes of this decrease are as follows:

- The workers’ compensation program experienced a loss. The loss was partially due to a decline in investment earnings. Additionally, by law, the supplemental pension cost-of-living adjustments granted for time-loss and disability payments are funded on a pay-as-you-go basis while the related costs are recognized at the time the injury occurs.
- High levels of unemployment related to the state’s economic recession resulted in unemployment compensation benefit payments exceeding unemployment compensation assessment revenue.

### Expenses and Program Revenues – Business-type Activities



### Revenues by Source – Business-type Activities



## Financial Analysis of the Government's Funds

As noted earlier, the state of Washington uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

**Governmental Funds.** As discussed earlier, the focus of the state of Washington's *governmental funds* is to provide information on near-term inflows, outflows, and balances of *spendable* resources. Such information is useful in assessing the state of Washington's financing requirements. In particular, *unreserved fund balance* may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

The General Fund is the chief operating fund of the state of Washington. At the end of the fiscal year, total fund balance for the General Fund equaled \$1.3 billion. Unreserved fund balance, the amount considered available to spend, totaled \$398 million. \$848 million of the General Fund fund balance relates to certain accrued revenues and has been designated for working capital purposes. It is not considered available to spend.

The fund balance of the state of Washington's General Fund decreased by \$144 million during the current fiscal year.

### State of Washington's General Fund

(in millions of dollars)

	Fiscal Year 2002	Fiscal Year 2001	Difference Increase(Decrease)
Revenues			
Taxes	\$ 10,342	\$ 10,562	\$ (220)
Federal grants	5,131	4,598	533
Investment revenue	20	103	(83)
Other	413	369	44
Total	15,906	15,632	274
Expenditures			
Human services	8,304	7,561	743
Education	6,778	6,608	170
Other	910	1,004	(94)
Total	15,992	15,173	819
Net transfers in (out)	(65)	(324)	259
Other financing sources	7	6	1
Net increase(decrease) in fund balance	\$ (144)	\$ 141	\$ (285)

The state's recession is reflected in decreased tax revenues and increased demand in human service programs. Declining interest rates, coupled with lower amounts available to invest, also had a negative impact on the General Fund. While the General Fund normally transfers resources to support activities of other funds, this was partially offset in Fiscal Year 2002 by the transfer in of resources from the Emergency Reserve Account and various other non-major governmental funds.

The Higher Education Special Revenue Fund and the Higher Education Endowment Fund are the other major governmental funds. During Fiscal Year 2002, the Board of Regents of the University of Washington approved the transfer of over \$200 million from the Higher Education Special Revenue Fund to the Higher Education Endowment Fund to establish an endowment.



Activity for the non-major governmental funds resulted in a reduction of net assets of \$306 million. Contributing to this reduction of net assets were transfers to the General Fund of \$335 from the Emergency Reserve Account and \$255.7 million from various other accounts. These transfers were made in accordance with legislative authorization to subsidize lower than expected General Fund revenues.

**Proprietary Funds.** The state of Washington's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail.

The Workers' Compensation Fund and the Unemployment Compensation Fund are major proprietary funds. Both experienced losses in Fiscal Year 2002 that are discussed previously under business-type activities. Activity for the various non-major proprietary funds resulted in an increase to net assets of \$45 million. The Risk Management Fund, an internal service fund, ended Fiscal Year 2002 with a loss of \$124 million. This loss resulted because funding for claims is provided on a pay-as-you-go basis while the claims expense is recorded as claims are incurred.

### **General Fund Budgetary Highlights**

Differences between the General Fund original budget and the final amended budget reflect adjustments to deal with the state's recession and are summarized as follows:

- Estimated tax revenues were decreased \$796 million.
- Resources provided by transfers in from other funds increased \$846 million.
- Appropriated expenditures decreased by \$400 million.

Differences between the General Fund final amended budget and actual expenditures are as expected at mid-point in the biennial budget – both actual revenues and expenditures approximating half of the appropriated amount.

### **Capital Asset, Infrastructure, Bond Debt Administration, and Subsequent Events**

**Capital assets.** The state of Washington's investment in capital assets for its governmental and business type activities as of June 30, 2002, amounts to \$20.1 billion (net of accumulated depreciation). This investment in capital assets includes land, infrastructure, museum and historical collections, buildings and other improvements, furnishings and equipment, as well as construction in progress.

Washington's Fiscal Year 2002 investment in capital assets, net of current year depreciation, was \$914 million, including increases to the state's highway infrastructure of \$607 million and buildings of \$237 million. The state's construction in progress includes both new construction and major improvements to state facilities including correctional facilities, ferry vessels and terminals, and buildings on the capitol and college and university campuses. Remaining commitments on these construction projects total \$2.6 billion.

Additional information on the state of Washington's capital assets can be found in Note 6 on pages 71-74 of this report.

**State of Washington's Capital Assets**  
**(net of depreciation)**  
*(in millions of dollars)*

	Governmental Activities	Business-type Activities	Total
Land	\$ 1,088	\$ 24	\$ 1,112
Highway system infrastructure and other assets not depreciated	11,174	-	11,174
Buildings	3,716	662	4,378
Furnishings, equipment and collections	1,250	85	1,335
Other improvements and miscellaneous	588	43	631
Construction in progress	1,141	300	1,441
Total	\$ 18,957	\$ 1,114	\$ 20,071

**Infrastructure.** Fiscal Year 2002 is the first year for the State of Washington to report infrastructure under the new requirements of GASB 34. Transportation infrastructure includes the state highway system, emergency airfields and a short rail line. While the rail line is reported net of depreciation, the state highway system and emergency airfields are reported using the modified approach. Under the modified approach, rather than recording depreciation, asset condition is reported. The rating scales for pavements, bridges and airfields are further explained in the notes and required supplementary information to the financial statements.

The Department of Transportation (WSDOT) manages state highways targeting the lowest life cycle cost per the Pavement Management System due date. While WSDOT has a long-term goal of no pavements in poor condition (a pavement condition index less than 40, on a 100 point scale), the policy for the current biennium is to maintain 90 percent of all highway pavement types at a pavement condition index of 40 or better with no more than 10 percent of its highways at a pavement condition index below 40. The most recent assessment found that state highways were within the prescribed parameters with only 9 percent of all pavement types with a pavement condition index below 40.

WSDOT manages state-owned bridges using the Washington State Bridge Inventory System (WSBIS). While WSDOT has a 20-year goal of no structurally deficient bridges, the policy for the current biennium is to maintain 95 percent of its bridges at a structural condition of at least fair, meaning that all primary structural elements are sound. The most recent assessment found that state-owned bridges were within the prescribed parameters with 96.7 percent having a condition rating of fair or better and only 3.3 percent of bridges having a condition rating of poor. Bridges rated as poor may have structural deficiencies that restrict the weight and type of traffic allowed. No bridges that are currently rated as poor are unsafe for public travel. Any bridges determined to be unsafe are closed to traffic. WSDOT does not have any closed bridges at the present time.

WSDOT owns and maintains eight emergency airfields. All but one are acceptable for general recreational use or a higher standard of use. The one airfield not up to that minimum standard is maintained as a limited search and rescue forward operating location only, and is expected to remain at that condition level.

Commitments made for infrastructure projects that extend beyond the current fiscal year to Fiscal Year 2003 amount to \$801 million, representing 1,273 projects.

**Bond debt.** At the end of Fiscal Year 2002, the state of Washington had total bond debt outstanding of \$8.7 billion, an increase of 7% over Fiscal Year 2001. Three times during the year, the state issued general obligation debt, totaling \$1 billion, for various capital and transportation projects as well as for refunding purposes. The state ranked 24<sup>th</sup> in amount financed by municipal issuers in 2001, according to *The Bond Buyer's 2002 Yearbook*.

Of the bond debt, \$8.3 billion is backed by the full faith and credit of the state; the balance is revenue bond debt issued by state institutions of higher education that is secured by specific sources of revenue.

### State of Washington's Bond Debt

*(in millions of dollars)*

	Governmental Activities	Business-type Activities	Total
General obligation (GO) bonds	\$ 7,997	\$ 187	\$ 8,184
Accreted interest on zero interest rate GO bonds	152	15	167
Revenue bonds	-	328	328
Total	<u>\$ 8,149</u>	<u>\$ 530</u>	<u>\$ 8,679</u>

The Washington State Constitution and the Revised Code of Washington limit the amount of general obligation (GO) debt that may be issued, the latter being the most restrictive. For the Fiscal Year ended June 30, 2002, the maximum GO debt authorized by statutory limit was \$5.96 billion. Specific bond issues and types that are not secured by general state revenues, such as motor fuel tax and reimbursable bonds, are excluded from the limitation. The state had \$5.41 billion of debt outstanding as of June 30, 2002, that was subject to the limitation.

By statutory provision, the State Finance Committee (SFC) is authorized to supervise and control the issuance of all state bonds, notes, or other evidences of indebtedness. The SFC is composed of the Governor, Lieutenant Governor and State Treasurer, the latter serving as chairman.

During the year, citing weak or slowly recovering Asian, national and state economies, rating agencies issued reassessments of the state's GO debt:

- Moody's changed the state's credit outlook from stable to negative in December 2001;
- Fitch lowered the state's rating to AA from AA+ in January 2002; and
- Standard & Poor's Rating Group (S&P) placed the state's rating on CreditWatch in March 2002. (Subsequently, in July 2002, S&P placed a negative outlook on Washington GO credit and removed it from CreditWatch).

At the end of Fiscal Year 2002, the state of Washington general obligation debt was rated Aa1 by Moody's Investor Service, AA by Fitch Ratings and AA+ by S&P.

Additional information on the state's bond debt obligations and the calculation of the legal debt limitation is presented in Note 7 beginning on page 75 of this report.

**Subsequent events.** The following events occurred after June 30, 2002, but are not expected to have a significant effect on the financial position or results of operations for the state of Washington. More information is available about these events in Note 13 of the financial statements on page 106.

- New debt issues, both bonds and certificates of participation for capital asset acquisition, were at normal levels.
- The state received \$450 million by securitizing a portion of its Master Tobacco Settlement Agreement in November 2002.
- Two voter-approved initiatives were approved which will reduce transportation revenues by an estimated \$9 million and increase estimated expenditures from the General Fund by \$1 million.

## **Economic Factors and Next Year's Budgets and Rates**

- The recession that impacted the state during Fiscal Year 2002 continues into Fiscal Year 2003 and is reflected in continued unemployment levels that exceed the national average.
- The Workers' Compensation program has adopted a 29 percent rate increase effective January 2003 to bring revenues more in line with the cost of benefits paid to workers injured on the job.
- Revenue forecasts for the remainder of the 2001-03 Biennium and the 2003-05 Biennium reflect fairly static growth in General Fund revenues.

Legislative leaders and management will consider these factors in preparing the state's budget for future years.

## **Requests for Information**

This financial report is designed to provide a general overview of the state of Washington's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be address to the Office of Financial Management, PO Box 43113, Olympia, WA 98504-3113.